



## ENHR 2006 workshop 2 Housing Finance

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## Private Equity Investment in Housing: The Case of Germany

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2

## Overview



1. The transformation of the German housing industry
2. The strategy of the Private Equity groups
3. REITs as an exit vehicle
4. Institutional alternatives

## **1. The Transformation of the German housing industry**

## Current supply side structure

58,5 per cent of the rented stock  
 •an advantage!  
 •but: other target group

Supplier	Number of dwellings in million units	Share in total housing stock in per cent
Private landlords	13,79	35,6
Municipal housing companies	2,74	7,1
Other public property	0,39	1,0
Housing cooperatives	2,29	5,9
Private housing companies	2,60	6,7
Churches	0,14	0,4
Other (e.g. banks, property funds, insurances)	1,61	4,2
Owner occupied	15,13	39,1
Total	38,69	100

eye-catching:  
 •low homeownership rate and  
 •big market share of private landlords

source: Rips 2005, S. 430

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5

## The current transformation of the German housing industry

### ■ Re-allocation of public housing stock

- fundamental change at the supply side
- Irrevocable substitution of public equity through private equity
- re-allocation of a large part of the public housing stock
- targeted housing stock mostly social dwellings (current or former)
- or former public property (Volkseigentum)



### ■ Open questions

- How will the supply side structure be affected??
- What will be the consequences for the self-conception of the housing industry and its employees?
- Social charters as placebos?
- Where is the political strategy?



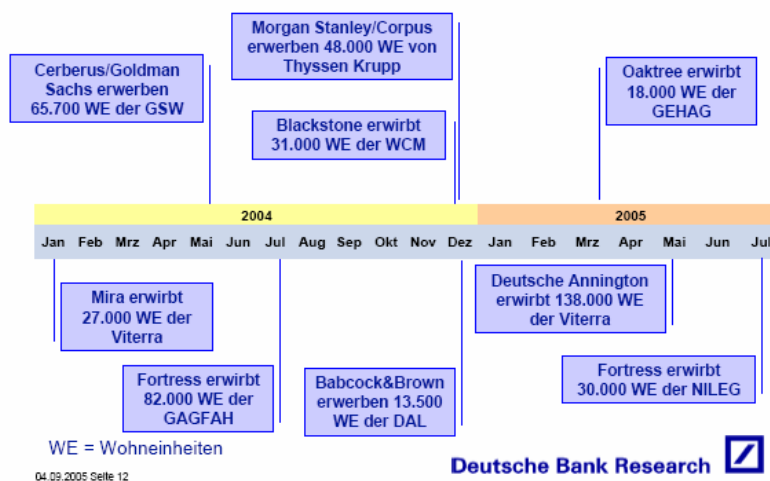
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## 2. The strategy of the Private Equity groups

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7

### Wichtige Transaktionen seit Anfang 2004

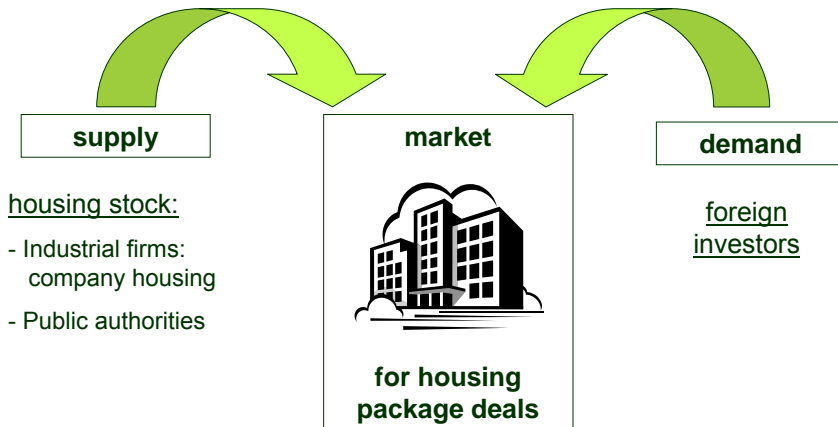


Deutsche Bank estimates that another Million of dwellings will be sold until 2010.

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8

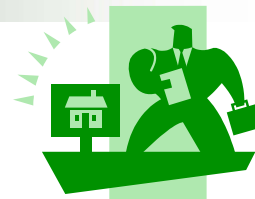
## Supply and demand



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## What is „Private Equity“?



- What is „Private Equity“
  - non-listed companies who collect large scale equity funds from private and institutional investors for their business of corporate raidership
- How do they work?
  - entrepreneurial engagement
  - investment approach value-oriented in the medium term (realise capital gains by selling off the holding)

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## Expected rates of return from different asset classes

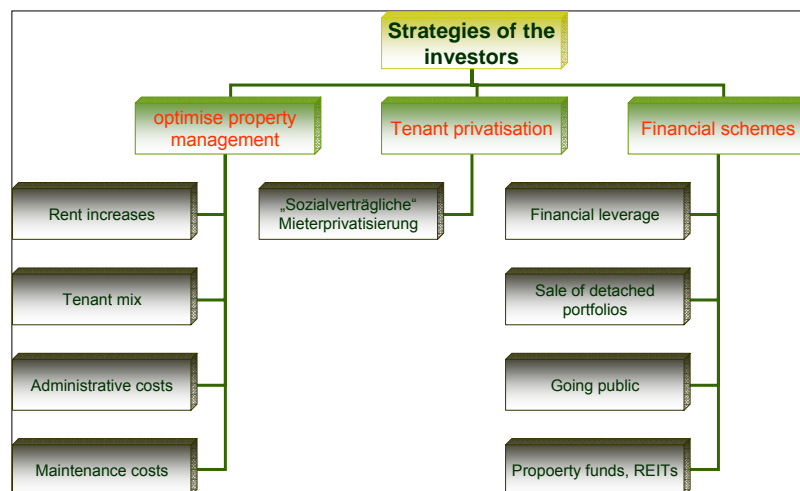
	before taxes (inflation 2 %)	after taxes (inflation 2 %)	5-7 % after taxes p.a. possible?	
traditional asset- classes	money market	ca. 2%	ca. 1%	no
	bonds	ca. 4%	ca. 3%	no
	shares	ca. 7-8%	ca. 4-6%	yes, but with high volatility
alternative asset- classes	Hedge Fonds	ca. 5-8%	ca. 3-5%	yes, but with high selective risk
	Real Assets (real property, crude materials, gold)	ca. 5-10%	ca. 3-7%	yes, but with high volatility and high selective risk
	Private Equity	ca. 10-15%	ca. 10-15%	yes, but positive cash flows only after 4-5 years

source: Schäfer 2005, Feri Wealth Management

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## The strategy of the investors



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## Optimising property management

chances	risks
rent increases: e.g. GAGFAH: 2005-2009: inflation rate +1,5% 2009-2014: inflation rate +3,0%	future potential for rent augmentations different between regions
tenant mix: homogeneous occupancy structures	instable neighbourhoods because of social segregation
administrative costs: outsourcing of services	personnel intensity of housing newly arising challenges (e.g. rent arrears)
maintenance: selective cutting of maintenance costs per square meter	competition parameter influence on property valuation

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13

## Tenant privatisation

### One of the most important value levers

#### ■ chances

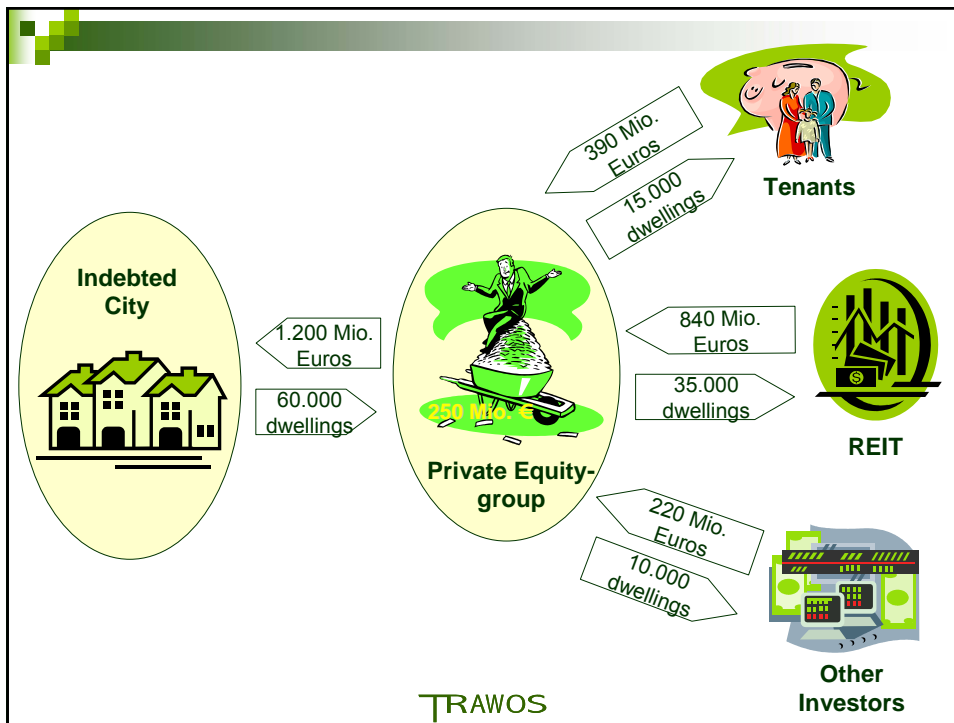
- low homeownership  
rate
- low price level
- low interest rates

#### ■ risks

- Eigenheimzulage  
abolished
- tenant mix
- remainder problem
- portfolio mix

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14



## The Fortress deals

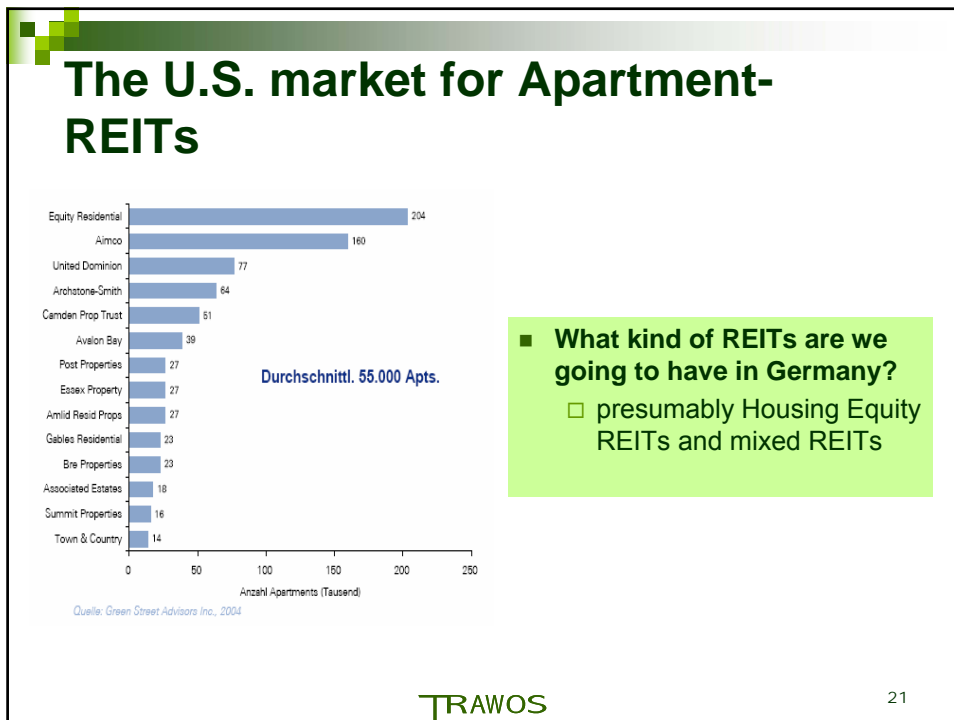
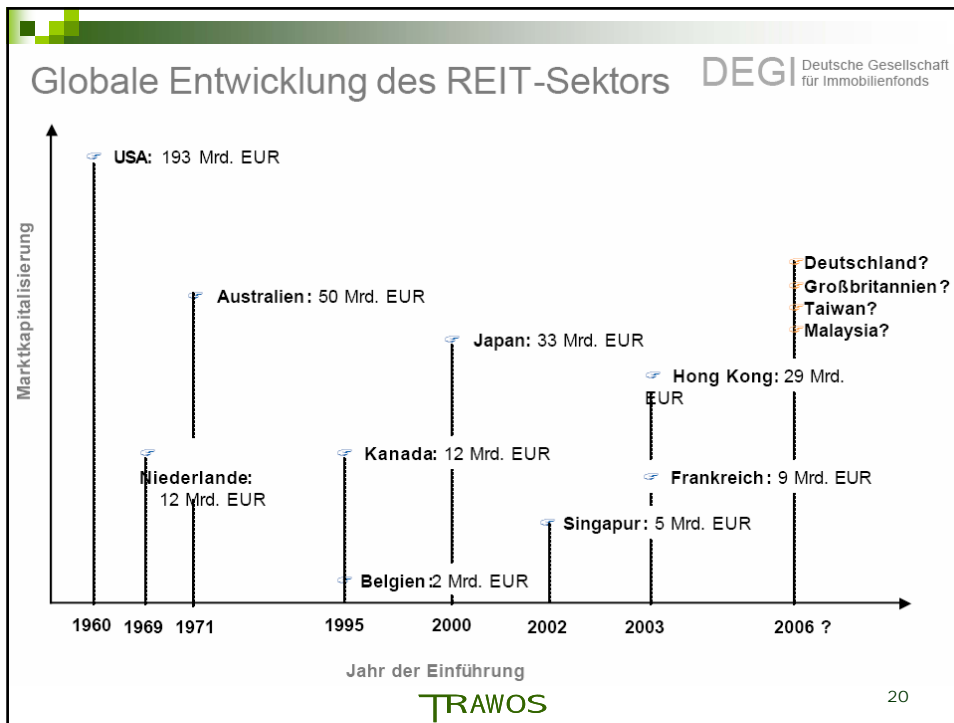
Company	Date of purchase	Number of dwellings	Price (Mrd. €)
Gagfah	07/2004	82.000	3,50
Nileg	07/2005	28.500	1,70
Woba	02/2006	47.600	1,75



### 3. REITs as an exit vehicle

### The role of REITs

- introduction of REITs will change the market for housing packages as well as the housing market in general
- re-allocation from direct to indirect ownership
- first wave of REIT issues will concentrate on housing:
  - only residential real estate is under-valued
  - Private equity groups already heavily invested in residential real estate → need an exit option for the non-privatisable dwellings



	Closed end property fund	Open end property fund	Real estate PLC	REIT
<b>Taxation</b>	Investor's level	Investor's level	Investor's level and company level	Investor's level
<b>Specialisation</b>	Project orientation	Broadly invested, some only in specific countries, almost no residential buildings	Not clear: rarely used investment form	Specialisation on specific market segments
<b>Fungibility</b>	No organised secondary market	Restitution: reliable?	Shares traded at the stock exchange	Shares traded at the stock exchange
<b>Valuation</b>	Little transparency	Once a year by independent appraisers	Continuous appraisal of the shares at the capital market	Continuous appraisal of the shares at the capital market
<b>Control</b>	Low control intensity	BAFin: state supervision of investment trusts	Corporate governance standards, capital market	Corporate governance standards, capital market, high distribution quota

## Privatisation with and without REITs

- no common instrument for investing indirectly in housing at present (no alternatives to Private Equity)
- substitutes for REITs?
- less takeovers by Private Equity without REITs or lower prices
- chance: REITs-privatisation without „brokers“, but:
  - wait until REITs were established at the capital market
  - transaction costs might be higher in a REIT-privatisation
  - regional accumulation risk makes simple conversion impossible (if size doesn't)
  - way out: merger of two or more housing companies (from different regions) and subsequent conversion into a REIT

## Future market structure with REITs – around 2015

- „rag rug ownership structure“
- higher homeownership rate
- much lower market share of municipal housing (might be even zero)
- Private equity already stepped out of the market
- REITs will hold a considerable part of former public housing stock
  - supra-regional mixed REITs oder
  - supra-regional housing REITs
  - presumably no regional housing REITs
- Market behaviour of REITs
  - more profit-minded
  - more transaction-oriented
  - „housing company“?
  - self-interested
  - not rooted in the communities
  - no partner for local housing policy

## 4. Institutional Alternatives



## An alternative approach to privatisation

- **Public Interest Housing**
  - less than 100 per cent municipal property
  - re-regulation: long run commitment to the principles of public interest housing
- **Social Mortgage Bond (SMB)**
  - financing of public interest housing with outside borrowed capital
  - interest income tax-privileged
- **Housing Investment Trusts (HITs)**
  - ethical investment in housing (RSL)
  - provide public interest housing with equity capital
  - municipalities can sell off part of their share
  - listed a stock exchange
  - special tax privileges

## The idea of public interest housing

- public interest ≠ public property
- idea in Germany discredited (Neue Heimat)
- as „Social enterprises“ part of the third sector
  - *mehr am Gemeinwohl als am Profit orientiertes Wirtschaften*
  - *Versorgungsauftrag und sozialpolitische Ziele im Vordergrund*
- institutional safeguarding of the specific public interest corporate culture (5 “S”):
  - Supervision of the sector
  - Self-administration (incl. Management efficiency)
  - Special legal form and depending regulation
  - Stand-alone courses of education
  - Stand-alone professional organisation

## In a nutshell

### Mission of the **Chartered Institute of Housing (CIH)**:

„To maximise the contribution that housing professionals (organisations) make to the well being of communities“

## Public interest housing as a form of intervention

- Special traits of the housing market as justification for state intervention
- Market failure and merit good characteristics: „The housing market is one of the most imperfect markets of all.“
- Forms of state intervention:
  - regulation (e.g. rent controls),
  - subsidies (e.g. social housing programmes, housing allowances),
  - information (e.g. housing needs forecasts) and
  - public interest housing.

## Why do we need public interest housing companies?

- hub function towards local authorities, charities and the like,
- neighbourhood management function (neighbourhoods as focal points of social policy),
- integrative function,
- participative function and
- pilot investment function.

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30

## Registration and supervision of public interest housing

- submission to a registration procedure and to a current surveillance (self-administration via auditing associations in cooperation with a supervisory body, e.g. "Housing Corporation")
- distribution limit
- cost covering rent calculation
- restrictions relating to product range (e.g. cheap housing) and target group (e.g. disadvantaged groups)
- efficient management of the housing stock
- narrower definition of the toleration duties in case of modernisation measures
- additional anti-discrimination requirements
- reservation of a certain share of the housing stock for municipal occupancy
- tenant participation, e.g. advisory committees, three thirds constituency structure
- equity participation of the locational communities
- cultural orientation towards the tenant's best and the best of the locational community

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31

	British REIT	German REIT	German HIT
Legal form	Capital company, listing obligatory	REIT-AG (PLC); separate trust capital, necessary listing sought	AG (PLC), listing not obligatory
Shareholder structure	Restriction on 10 per cent of the shareholder's capital	No restriction	Restriction on 25 per cent of the shareholder's capital
Income- / asset structure	minimum 75 per cent of distribution qualified real estate income	minimum 75 per cent of income from rent and lease	Minimum two thirds of non-current assets shares in public interest housing
Secondary business	Maximum 25 per cent	Maximum 20 per cent from secondary business via subsidiaries	Maximum one third of non-current assets otherwise invested, minimum 50 per cent thereof in real estate including mortgages and mortgage covered bonds
Management	Internal Management	External option for separate trust capital	Internal Management
Profit distribution	95 per cent minimum distributable	Minimum 90 per cent of distributable trust profit	75 per cent minimum distribution
Assessment basis of distribution	Qualified real estate income	Revenue including realized capital gains (if not re-invested or allocated to investment reserve)	Real estate income including realized capital gains (if not re-invested or allocated to investment reserve), but without capital gains from shares in public interest housing
Minimum capital / debenture capital	No minimum capital, max. 2,5 : 1 (debt / equity)	Minimum capital € 5 Mio., trust capital € 50 Mio., no limit on debt / equity ratio	Minimum capital € 240.000, max. 3 : 1 (debt / equity)
Tax exemption	Tax exemption for „qualified real estate income“ at the trust level	Tax exemption at the trust level if minimum distribution is paid out	At the trust level tax exemption for income from shares in public interest housing  At the investor's level tax advantage in comparison with other capital investments including REITs with limited regressive distributive effects

32

## SMBs

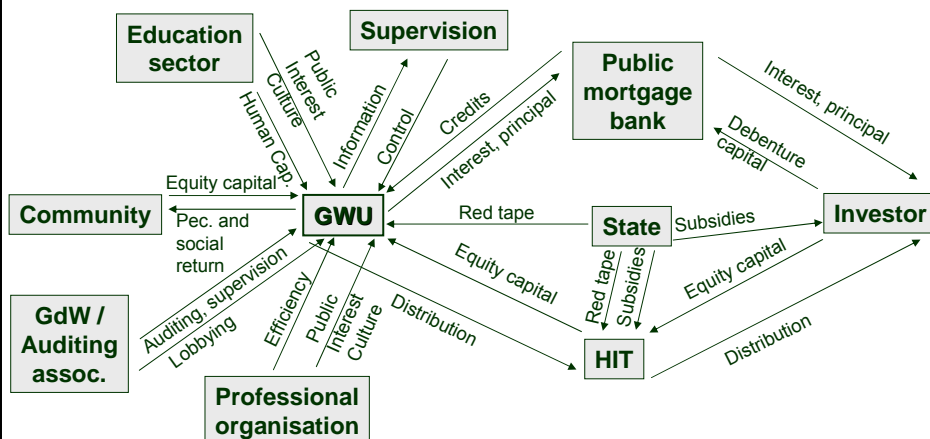
- based on the Austrian “Wohnbauanleihe”
- tax-privileged: interest revenue taxed lower than revenue from other comparable capital investments, possibly with limited regressive distributive effects
- issued by public mortgage banks
- underwriting revenue only for granting mortgages to RSL
- no obligation to finance real estate investment in the first five years after the introduction of SMBs → re-finance other debt or take up additional debenture capital
- own segment of the general bond market
- equilibrium of after tax rates of return for comparable bonds (risk, duration)
- cheap refinance instrument for SMB issuers



## Taxation of SMBs

- An important part of the acquisition costs for the first purchase can be deducted as special expenses from the income tax burden if the SMB is lodged with a bank for at least 10 years.
- Interest revenue is tax-free up to the base interest rate of the European Central Bank. Additional interest revenue is to be taxed with a lump sum rate of 20 per cent.
- Realised capital gains are fully taxable within the speculative period.

## The future structure of public interest housing: a first sketch



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